

Mr. Robinson expressed support for establishing requirements that are consistent with NASBA's requirements.

III. Consideration of CalCPA's Request for Amendments to the Board's Regulations Related to Audit Documentation Requirements.

Mr. Blanc indicated that the Board had received a letter from CalCPA dated August 17, 2005, requesting conformity between the Board's regulations and the Public Company Accounting Oversight Board's (PCAOB's) audit documentation requirements (see Attachment 2). He asked Mr. Schultz to provide information on the CalCPA proposal.

Mr. Schultz began his presentation with a historic overview. He indicated that, after the Enron crisis, the Board organized a task force that identified critical issues related to the regulation of the public accounting profession. Audit documentation was one such issue. Mr. Schultz indicated that the task force and the Board did extensive work in this area, and that one outcome was a comprehensive set of audit documentation requirements.

Mr. Schultz noted that when the PCAOB was created, one of its first projects was the development of audit documentation requirements. In developing its standard, the PCAOB received input from a wide range of stakeholders and gave extensive consideration to California's requirements. Mr. Schultz explained that now that the PCAOB's standard is in place, CalCPA is recommending that the Board consider conforming its regulations with that standard. One reason for this recommendation is that CalCPA believes cooperation for enforcement purposes would be enhanced because the Board and the PCAOB would be holding licensees to the same requirements. CalCPA also believes the compliance by firms would be enhanced since firms would not need to give special consideration to determining what rules apply.

Mr. Schultz noted that CalCPA is not suggesting that the Board adopt the entire PCAOB standard, which is much more detailed than would be appropriate for a Board regulation; nor are any statutory changes being proposed. He then explained that the proposed changes to the regulations were in three areas. The first proposed change related to the start of the seven-year document retention period. The Board's requirement starts the document retention period on the report date, which is printed on the audit report and indicates the date when the fieldwork was completed. Following that date, the financial statements are pulled together and proofread and the report is issued – generally less than a month later. The PCAOB starts the seven-year retention period on the date the report is issued which is referred as the report issuance date or the report release date. Both the PCAOB and the Board require that the two dates be documented.

Mr. Schultz added that the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) has an exposure draft which addresses audit documentation for audits of nonpublic companies. It changes the definition of the report date to the date when the field work is completed and the auditor is satisfied with the

adequacy of the financial statements. He noted that this brings the report date and the report release date very close together since by the time the auditor is satisfied with the financial statements, he or she is usually ready to release the report. He noted that this change may make the distinction moot.

Mr. Schultz reported that the second difference is that California allows a documentation completion period of 60 days during which certain things can be done to finalize the audit documentation. The PCAOB allows 45 days. He added that the ASB exposure draft specifies 60 days.

Mr. Schultz indicated that the third difference relates to the deletion of documents. He noted that both California and the PCAOB require that the auditor retain documentation related to significant matters including documentation that is contrary to the final conclusion. Also, both allow other documentation to be discarded. He pointed out that documents that can be discarded are discussed in paragraph A54 of the PCAOB's standard (see Attachment 2).

He then explained that the difference between the Board's requirement and the PCAOB standard is that the PCAOB standard permits deletion of extraneous documents during the documentation completion period, without the need to document these deletions. The Board requires that, if something is deleted during the documentation completion period, the deletion must be documented. Mr. Schultz indicated that it was his understanding, based on discussions by the CPC and the Board at the time the Board's requirement was under consideration, that to comply with the Board's regulation and appropriately document the extent of the deletion it would be necessary to keep the document being deleted as a reference. He suggested that this is a burdensome requirement and could potentially affect audit quality because to comply with this requirement the auditor must focus on deleting extraneous documents before the report is released rather than focusing on tasks more germane to the quality of the audit report. He indicated that this is the most significant part of the CalCPA proposal and that they urge the Board to modify its regulations to allow insignificant, extraneous, duplicative materials to be deleted during the documentation completion period.

Mr. Schultz then commented on the letter from Ms. D'Angelo Fellmeth of the Center for Public Interest Law (CPIL) that had been provided to the CPC and the Board (Attachment 3). He noted that CPIL argues that the regulations are too new to change. In response he stated that he believed this was a unique situation in that there is a standard developed after significant public comment by an independent, public-sector standard-setting body with very competent, professional staff. He believed it makes sense to consider conforming in this instance, rather than waiting to see how the lack of conformity plays out over a period of time. He added that CPIL's second argument was that the PCAOB's standard was not intended to occupy the field. Mr. Schultz indicated that CalCPA agrees with this point. He noted that CPIL's third argument is that CalCPA's proposal does not use the same terminology that the PCAOB uses. The PCAOB uses the term "report release date" and CalCPA, in conformance with other language in the Board's regulations, uses the term "date of issuance of the report." He

indicated that CalCPA's language was chosen to minimize the number of changes to the Board's regulations, but that CalCPA had no objection to using either term. He added that if the Board wanted to include a definition of "report release date," the PCAOB definition would need to be modified to apply to audits of entities other than public companies. Mr. Schultz added that a fourth point was that CPIL objected to the deletion of the definition of "changes in audit documentation." He explained that the reason for this was that the definition is not necessary because the PCAOB language focuses instead on what the auditor can and cannot do. Mr. Schultz commented on the quote at the end of the CPIL letter which is from the PCAOB's June 2004 document. He noted that the quote is from paragraph A56 of the PCAOB standard (see Attachment 2) which addresses the very unusual circumstance in which audit evidence is obtained and documented after the report release date. He added that this is not relevant to the normal circumstances of most audits.

Ms. D'Angelo Fellmeth then provided comments. She began by reminding participants that prior to 2002 there were no statutes or regulations, on either the state or the federal level, mandating the retention of audit documentation. The Enron and WorldCom crises changed all that. The federal government enacted the Sarbanes-Oxley Act (SOX) and California enacted AB 2873 (Frommer). She noted that both of these bills encouraged the creation of strong audit documentation standards. After AB 2873 was enacted, all of the stakeholders spent many months painfully crafting implementing regulations. The regulations were adopted by the Board on May 16, 2003, with the consensus of all stakeholders, and became effective on January 23, 2004. She indicated that CPIL believes that it is too soon to consider revisions, especially since no problems have resulted from the current regulations.

She then indicated that CPIL also objects to the content of the CalCPA proposal. She noted that the CalCPA proposal uses the term "date of issuance of the report" which is not defined by the PCAOB. She added that Mr. Schultz had previously indicated that CalCPA would be willing to use the PCAOB term, and CPIL has no problem with this change as long as it is used consistently throughout the regulations. She then commented that CPIL is much more concerned about the proposed revisions to Section 68.4 which would delete the definition of the term "changes in audit documentation." She noted that she believed the proposal creates a huge loophole that allows editing, removal, or substitution after the report release date without any recording of who authorized it and why. She indicated that she believed this was contrary to the intent of the enabling legislation and contrary to the Board's intent when the regulation was adopted. She urged the Board to reject the proposed revisions.

Mr. Robinson then commented that his clients, the Big Four accounting firms, are interested in conformity. He agreed with Ms. Fellmeth that the regulations were painfully crafted and were developed before the PCAOB proposed its standard. He then noted that the national standard the PCAOB developed is in many ways consistent with the Board's requirements, but it is at variance in some ways as well. He noted that his clients use the same standards for audits of other entities that they use for public company audits and would prefer to have one national standard with which to comply.

During the discussion, Ms. Sos stated that she was unclear why it was concluded that the Board's regulations require the retention of deleted documents. Mr. Schultz responded that California requires that the record of the deletion be sufficient so that a knowledgeable reviewer with no previous connection with the audit can understand the nature, timing, reason for, and the extent of the change. He indicated that he remembered the discussion related to recording "the extent of the change" for a deleted document and that the conclusion was that the way to document "the extent of the change" was by retaining what was being deleted. Mr. Schultz indicated that he believed the PCAOB's approach was better.

He further indicated that any change to the Board's regulation that would permit the deletion of documents related to insignificant matters during the document completion period would resolve much of the problem. He noted that the documents in question are all documents that could be deleted before the report release date, under California's regulation. He observed that it would be possible to wait and not release the report until the documentation process was complete, but that would not be desirable because timeliness is a significant aspect of financial information.

Mr. Blanc inquired how deletions after the document completion date were addressed in CalCPA's proposal. Mr. Schultz responded that deletions would be barred after the document completion date. After the document completion date, items may be added to the file, but this must be documented. Also, if anything is edited, there must be a record of what was there prior to editing.

Ms. Hillebrand indicated that she was concerned about permitting deletions based on a reliance on the standard which indicates what material must be retained. She noted that there is an element of judgment involved in determining what should be deleted, and it is useful to have a record of who is making that determination.

Mr. Iino inquired about requirements in other states. Mr. Schultz indicated he believed New York has a comprehensive requirement, while Texas requires retention for a specified number of years. He noted that NASBA's rule specific to audit documentation is similar to the ASB. Mr. Duffey added that some other states have a requirement that documents be kept for seven years. He observed that, after the PCAOB developed its standard, other states stopped their activities in this area.

Mr. Swartz noted that there are a lot of papers that are accumulated in the file, and that giving people 45 days to delete documents that could have been deleted earlier does not strike him as a significant concern. It was then moved by Mr. Swartz and seconded by Dr. Charney to accept CalCPA's proposal and also to clarify the definition of report release date.

Mr. Blanc indicated he believed there were difficulties involved in adopting CalCPA's proposal without any modifications. Ms. Hillebrand agreed, and expressed concern regarding permitting the deletion of items with no record of who was responsible for the

deletion. She also observed that CalCPA's proposal employs a model developed for audits of public companies and it needs to be evaluated to determine if it is suitable for audits of other entities as well. She also noted that the issue of whether the Board's regulation requires the retention of deleted items needs further exploration. She suggested that perhaps insignificant or duplicative items could be deleted if there was a record of who decided to delete them and the date of the deletion.

Mr. Swartz asked why it would make a difference if a document was deleted before the report release date instead of ten days after that date. Ms. Hillebrand indicated that the release date is the date when the document has an impact on third parties. If something is deleted later, the documentation may not support the information in the report. She also indicated she was concerned because there is judgment involved in determining what is insignificant and can be deleted, and she believed it was important to have a paper trail showing who makes that determination.

Ms. Sos indicated she believed the CPC and the Board needed to be cautious about making changes to the current regulations. She suggested that a simple modification to the existing regulation could address the concern that compliance with the Board's regulation required the retention of deleted documents. She further indicated she believed the Board should give consideration to the ASB exposure draft before modifying its requirements.

After discussion, the CPC voted on Mr. Swartz' motion. The motion did not carry (2 "ayes," 4 "noes"). It was then moved by Ms. Sos and seconded by Mr. Swartz to **continue the discussion at the next meeting and to include in that discussion consideration of the ASB audit standard especially with regard to the number of days permitted for the assembly of documents and the cut-off date, consideration of a possible revision to subsection (b) of Section 68.4 so that the last sentence begins with language such as "The documentation regarding the change shall contain..." to clarify the requirement related to the deletion of documents, and consideration of the addition of a new subsection to Section 68.4 to not permit the deletion or discarding of documents after a specified date.** Mr. Robinson asked that, when this matter is considered by the Board again, there be a side-by-side comparison so that the Board can be informed regarding which changes will result in conformity with the PCAOB standard. Ms. Sos agreed to accept this as part of the motion. The motion was unanimously carried.

IV. Proposed Revision to Business and Professions Code Section 5134 Related to Fees and the Reserve.

Mr. Rich reported that, at the September 2005 Board meeting, staff presented a fee analysis with recommendations related to the reserve amount in the Accountancy Fund. At that meeting, the Board decided to pursue four statutory changes and asked that staff develop language to implement that decision. He noted that two of the changes were related to the elimination of the requirement that fees for the examination and for licensure approximately equal the administrative cost of the programs. The third



University of San Diego

Attachment B

Center for Public Interest Law

Children's Advocacy Institute

Energy Policy Initiatives Center

November 15, 2005

Renata M. Sos, President, and Members
California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

re: CalCPA's Request to Amend Sections 68.3 and 68.4,
Title 16 of the California Code of Regulations

Dear Ms. Sos and Board Members:

I write to express the concerns of the Center for Public Interest Law (CPIL) about the request by the California Society of Certified Public Accountants (CalCPA), in its letter dated August 17, 2005, for amendments to sections 68.3 and 68.4, Title 16 of the California Code of Regulations.

As many Board members know, these regulations were adopted to implement Business and Professions Code sections 5097 and 5098, which were enacted by the California Legislature in 2002 as part of a multi-bill response to the unprecedented accounting scandals at Enron, WorldCom, and other publicly-traded companies.¹ Effective January 1, 2003, section 5097 enacts strong standards to encourage the creation of adequate audit documentation and the retention of that audit documentation for seven years. Sections 68.3 and 68.4, which implement these audit documentation standards, were adopted by this Board effective January 23, 2004 — these regulations were the product of many months of work by the Board's Reform Statutes Implementation Task Force and its Committee on Professional Conduct, and three lengthy public hearings at which many stakeholders actively participated by submitting both written and oral testimony (October 31, 2002; April 30, 2003; May 16, 2003). In the end, when the Board finally adopted these (and other) regulations on May 16, 2003, its vote was unanimous and reflected a consensus among all the stakeholders.

In the meantime, the Public Company Accounting Oversight Board (PCAOB), which was created in the federal Sarbanes-Oxley Act of 2002, became operational. In September 2003 — after CBA had already adopted its audit documentation regulations — the PCAOB commenced a federal rulemaking proceeding which culminated in its adoption of *Auditing Standard No. 3: Audit Documentation*. That standard did not become effective until November 15, 2004.

¹ During 2002, the California Legislature enacted AB 270 (Correa and Figueroa) (Chapter 231, Statutes of 2002), AB 2873 (Frommer) (Chapter 230, Statutes of 2002), and AB 2970 (Wayne) (Chapter 232, Statutes of 2002) in reaction to the 2001-02 crisis in the accounting profession. Business and Professions Code sections 5097 and 5098 were part of AB 2873 (Frommer).

In its August 17, 2005 letter, CalCPA seeks amendments to sections 68.3 (which addresses the retention period for audit documentation) and 68.4 (which governs changes in audit documentation). CPIL has the following concerns about this request.

1. These regulations are simply too new to change.

CBA's regulations, which became effective on January 23, 2004, are not even two years old. PCAOB's regulation became effective on November 15, 2004 — so it is barely one year old. Neither CBA nor PCAOB have sufficient experience with them to warrant change at this time. CalCPA has neither articulated nor demonstrated any harm, inconvenience, or problem due to the fact that CBA's regulations differ slightly from PCAOB's regulations. This Board expended considerable time and effort crafting its regulations through three public hearings and multiple substantial changes. It is too soon to begin tinkering with them now.

2. PCAOB's regulations are not intended to "occupy the field" or preempt California laws or regulations.

This argument will sound familiar to veteran Board members. Although CalCPA seeks "conformity" with federal regulations, such conformity is not required. Nothing prevents the California Board from adopting regulations that vary from PCAOB's regulations. As stated in the Assembly Floor analysis of AB 2873 in response to the "conformity" argument raised by the large accounting firms in opposition to that bill during 2002: "The federal government does not 'occupy the field' of licensure or regulation of accountants. . . . Each state has the right to craft legislation to meet consumer and investor protections as they arise. According to the Legislative Counsel there is no federal preemption in this area."² Thus, it is perfectly permissible for CBA to have regulations that slightly differ from those of PCAOB.

3. CalCPA's proposed regulations do not conform to PCAOB's regulations.

Although CalCPA says it wants to conform California's regulations to the PCAOB's *Auditing Standard No. 3*, CalCPA's proposal varies from the PCAOB standard. For example, CalCPA would amend section 68.3(a) to trigger the audit documentation retention period on the "date of issuance of the report." However, the PCAOB standard triggers the retention period on the "report release date," defined as "the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements."³

In its June 9, 2004 Release (part of which is quoted by CalCPA in Attachment 3 to its August 17, 2005 letter), the PCAOB was very precise in defining and utilizing "two significant dates" in its audit documentation standard. According to the PCAOB, "[t]o ensure quality and consistency in the preparation and retention of audit documentation, the standard defines two important dates: (1) the report release date and (2) the documentation completion date. The *report release date* is the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. After the report release date, auditors will have 45 days to assemble a complete and final set of audit documentation. The end of this 45-day period is the *documentation completion date*" (italics original).

² Assembly Floor Analysis of AB 2873 (Frommer) (August 19, 2002).

³ Public Company Accounting Oversight Board, *Auditing Standard No. 3: Audit Documentation*, ¶ 14.

Although Attachment 2 to CalCPA's letter asserts that the terms "report release date" and "date of issuance of the report" are equivalent, it would appear more prudent to use the PCAOB's term and definition. CPIL would not object to an amendment to section 68.3(a) as follows:

68.3(a). The retention period mandated by Business and Professions Code Section 5097 shall be measured from the report release date, as defined by the Public Company Accounting Oversight Board.

4. CalCPA's version deletes the definition of the term "changes in audit documentation."

CalCPA proposes to completely rewrite section 68.4, which is currently entitled "Changes in Audit Documentation After Issuance of the Report." Of significance and of greatest concern to CPIL, CalCPA proposes deletion of section 68.4(a), which defines the term "changes in audit documentation" to include "any addition, removal, deletion, substitution, or editing of audit documentation, including, but not limited to, physical or electronic additions to any audit documentation file or preexisting audit documentation." This definition in section 68.4(a) is absolutely necessary to carry out the intent of existing section 68.4(b).

CPIL opposes the deletion of this definition (and notes that CalCPA did not oppose it when it was adopted by this Board on May 16, 2003). This definition was extremely important to this Board when adopting its original regulations. This Board's Initial Statement of Reasons (issued January 31, 2003) found that "adoption of section 68.4 is necessary to specify in regulation the procedures for identifying and dating changes in audit documentation. This matter was considered in meetings of the Board's Reform Statutes Implementation Task Force and the full Board. Proposed section 68.4(a) is a result of those discussions. After discussion, *the Board concluded that it is necessary to specify requirements for changes in audit documentation as such changes are sometimes an issue in disciplinary matters*" (emphasis added). Deletion of this comprehensive definition will only lead to litigation of the meaning of the word "change" — which should clearly include not just "addition" but also "removal, deletion, substitution, or editing" of either "any audit documentation file or preexisting audit documentation," as defined by the current regulation.

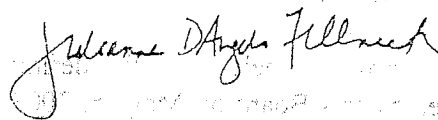
CPIL invites Board members to compare the existing sections 68.4(a) and (b) with those sections as CalCPA proposes to amend them. The amended versions do not accomplish the objectives of the existing sections, as follows:

- (1) As noted above, CalCPA would delete the definition of "changes in audit documentation" in 68.4(a) — which CPIL opposes.
- (2) CalCPA would substitute new language in section 68.4(a) — all of which comes verbatim from the PCAOB's regulation. However, that language does not define the term "changes in audit documentation."
- (3) Existing section 68.4(b) applies documentation requirements to all "changes in audit documentation" as defined in section 68.4(a). However, CalCPA would amend section 68.4(b) to limit its documentation requirements solely to "additions" made after the report release date. Although section 68.4(b) includes detailed procedural requirements regarding "additions" to audit documentation, it does not deal with

"removal, deletion, substitution, or editing" of audit documentation between the report release date and the documentation completion date. In other words, the following sentence of section 68.4(b) — "Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added" — appears to permit the "removal, deletion, substitution, or editing" of audit documentation *between* the report release date and the documentation completion date. This is contrary to the PCAOB's June 9, 2004 Release ("auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date") and with the intent of this Board just two years ago when it adopted section 68.4.

In sum, CPIL would agree to amend section 68.3 (and perhaps other sections) to change the term "report date" to "report release date" as defined and utilized by the PCAOB. However, it opposes the significant and unwarranted changes to section 68.4 that have been proposed by CalCPA. Thank you for your consideration of these comments.

Sincerely,

A handwritten signature in cursive script, reading "Julianne D'Angelo Fellmeth".

Julianne D'Angelo Fellmeth
Administrative Director
Center for Public Interest Law

BUSINESS AND PROFESSIONS CODE SECTIONS 5097- 5098

5097. (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.

(b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.

(c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

(d) Audit documentation shall be maintained by a licensee for the longer of the following:

- (1) The minimum period of retention provided in subdivision (e).
- (2) A period sufficient to satisfy professional standards and to comply with applicable laws and regulations.

(e) Audit documentation shall be maintained for a minimum of seven years which shall be extended during the pendency of any board investigation, disciplinary action, or legal action involving the licensee or the licensee's firm. The board may adopt regulations to establish a different retention period for specific categories of audit documentation where the board finds that the nature of the documentation warrants it.

(f) Licensees shall maintain a written documentation retention and destruction policy that shall set forth the licensee's practices and procedures complying with this article.

5098. The board may adopt regulations to implement, interpret, and make specific provisions relating to the following:

(a) Requirements for licensees maintaining an audit documentation retention policy and procedures for review and approval of audit documentation destruction.

(b) Procedures for the identification, dating, and retention of audit documentation.